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No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF AUTHORITIES

Cases:	Page
Baylin v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995)	3
Benci-Woodward v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001)	3, 4, 5
Coady v. *Commissioner*, 532 U.S. 972 (2001)	5
Commissioner v. *Sunnen*, 333 U.S. 591 (1948)	4
Cotnam v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959)	3
Davis v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000)	3
Estate of Clarks v. *United States*, 202 F.3d 854 (6th Cir. 2001)	3
Helvering v. *Horst*, 311 U.S. 112 (1940)	6, 8
Hukkanen-Campbell v. *Commissioner*, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002)	2, 5
Kenseth v. *Commissioner*, 259 F.3d 881 (7th Cir. 2001)	2
Lucas v. *Earl*, 281 U.S. 111 (1930)	8
O'Brien v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963)	3
Raymond v. *United States*, 355 F.3d 107 (2d Cir. 2004)	6, 7
Sinyard v. *Rossotti*, 536 U.S. 904 (2002)	5
Young v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001)	2
Statute:	
Internal Revenue Code (26 U.S.C.):	
§ 61(a)	2
§ 212(1)	6

Miscellaneous: Page

Bill Summary & Status for the 108th Congress (referred to House Comm. Mar. 6, 2003) <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.01155:> 9
Bill Summary & Status for the 108th Congress (referred to Senate Comm. Mar. 6, 2003) <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:s.00557:> 9
H.R. 1155, 108th Cong., 1st Sess. (2003) 9, 10
S. 557, 108th Cong., 1st Sess. (2003) 9, 10

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Respondent has provided no persuasive reason for this Court to leave unreviewed the Sixth Circuit's decision holding that litigation proceeds paid to a taxpayer s attorney pursuant to a contingent fee agreement are never includible in the taxpayer's gross income, *regardless* of how state law defines the attorney's interest in the proceeds. As explained below and in the petition for a writ of certiorari (Pet. 7-17), the court of appeals' decision is inconsistent with decisions of the Second, Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits, and it exacerbates a pre-existing circuit conflict over the tax treatment of

contingent fees paid to attorneys out of the proceeds of litigation brought by a taxpayer.

Respondent does not seriously dispute that the courts of appeals are divided over the question presented in the petition. See Br. in Opp. 5-6. Instead, he complains (*id.* at 2-5) that the government has opposed certiorari in prior cases raising the same or a similar question and has taken the position that the court of appeals decisions in those cases did not create a direct circuit conflict. He also contends that the decision below was correct (*id.* at 6-8), and that pending legislation in Congress might, if enacted, lessen the significance of the question presented in this case (*id.* at 8-10). None of those arguments provides a basis for denying certiorari in this case.

1. a. Prior to the Sixth Circuit's decision in this case, the courts of appeals had adopted two approaches to the question whether litigation proceeds paid to a taxpayer's attorney pursuant to a contingent fee agreement are includible in the litigant's gross income under 26 U.S.C. 61(a). The Fourth, Seventh, and Tenth Circuits had held that as a matter of federal law such proceeds are always includible in the litigant's gross income. See *Young* v. *Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001); *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001); *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002). The Third, Fifth, Sixth, Ninth, Eleventh, and Federal Circuits had held that the tax treatment of contingent fee proceeds turns on whether state law treats the contingent fee arrangement as merely providing the attorney a lien on the proceeds of the litigation, similar to liens afforded other creditors, or whether it effects an "assignment" or transfer to the attorney of a part of the litigant's cause of action.

See, *e.g.*, *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2001); *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001); *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995).

The Sixth Circuit in this case rejected both of those approaches. Like the Fourth, Seventh, and Tenth Circuits, the Sixth Circuit held that the proper tax treatment of contingency fee proceeds "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." Pet. App. 23a-24a (citation omitted). But unlike each of those circuits, the court of appeals below held that as a matter of federal law such proceeds are *never* includible in the litigant's gross income. *Id.* at 25a. The decision below therefore directly conflicts with the decisions of the Fourth, Seventh, and Tenth Circuits.

It also conflicts with the decisions of those courts of appeals that have looked to state law to determine the tax treatment of contingency fee proceeds. Most directly, the decision below conflicts with the Ninth Circuit's decision in *Benci-Woodward* v. *Commissioner*, *supra*. In *Benci-Woodward*, the Ninth Circuit held that a contingent fee agreement made under California law gives the attorney only a lien on the client's prospective recovery and does not transfer to the attorney any proprietary interest in the client's cause of action. 219 F.3d at 943. Accordingly, the court held, it necessarily follows that the entire amount of the damages awarded to the taxpayer, including the por-

tion that is paid directly to the taxpayer's attorneys under the contingent fee agreement, must be included in the taxpayer's gross income. *Ibid.*

As in *Benci-Woodward*, the contingent fee agreement in this case was made under California law. Far from taking issue with the Ninth Circuit's interpretation of California law, the Sixth Circuit quoted it with approval. Pet. App. 23a. It nevertheless held that contingent fee proceeds could not be included in the litigant's gross income, even though under applicable state law the attorney was treated like other creditors and had no ownership interest in the litigant's cause of action. As the court explained, it simply decided that it would "not * * * draw distinctions based on the lien theory of the particular state in which an action arises." *Ibid.*

Prior to the decision in this case, *every* court of appeals to consider the issue had held that litigation proceeds paid to a taxpayer's attorney as contingent fees are includible in the taxpayer's gross income where state law defines the interest conferred on the attorney by the contingent fee agreement as a security interest rather than an ownership interest. After the Sixth Circuit's decision, two litigants with identical claims and identical contingent fee agreements made under California law could be subject to starkly different tax treatment on their litigation proceeds based solely on the jurisdiction in which the tax dispute was brought. It is precisely such "inequalities in the administration of the revenue laws" that this Court has sought to avoid. *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948).

b. Nothing in the government's briefs opposing certiorari in *Benci-Woodward* and the other cases cited by respondent (Br. in Opp. 2-6) undermines the conclusion that this Court's review is needed to resolve

the widening circuit conflict on the question presented in the petition. In its brief opposing certiorari in *Benci-Woodward*, the Government noted that "[i]n none of the cases on which petitioner relies did a court hold that a plaintiff who merely gives a contractual lien to an attorney—and who does not assign to the attorney ownership rights in the cause of action—need not include the entire award in his gross income." Br. in Opp. at 6-7, *Benci-Woodward*, *supra* (No. 00-592); see Br. in Opp. at 5, *Hukkanen-Campbell*, *supra* (No. 01-1348) (arguing that "[f]or the same reasons stated in our brief in opposition to the petition for a writ of certiorari in *Benci-Woodward*, the petition for a writ of certiorari should be denied in this case"); Br. in Opp. at 4, *Coady* v. *Commissioner*, 532 U.S. 972 (2001) (No. 00-1326) (same); Br. in Opp. at 8-9, *Sinyard* v. *Rossotti*, 536 U.S. 904 (2002) (No. 01-1380) (same). That, however, is precisely the holding of the Sixth Circuit below, and that holding adds a new and divergent decisional approach to the pre-existing conflict over whether such proceeds must always be included in the taxpayer's gross income, or must be included only when state law does not provide the lawyer with an ownership interest in the taxpayer's cause of action.

c. Ultimately, respondent appears to concede the existence of a "conflict between the decision of the court of appeals below and *Benci-Woodward* * * * over the practical significance of California's attorney lien law." Br. in Opp. 5-6. But he contends that "such a shallow, recent, and narrow conflict does not merit review by this Court." *Id.* at 6. Respondent is mistaken. This Court's review is necessary to resolve the conflict over the proper tax treatment of litigation proceeds paid directly to the taxpayer's attorneys

under a contingent fee agreement, and this case provides an ideal vehicle for addressing that issue.

Contingent fee agreements are an important and common feature in many types of litigation. The question presented in this case therefore recurs frequently and has substantial importance to the proper administration of the tax laws. As the discussion above and in the petition for a writ of certiorari demonstrate, the conflict over this question is widespread and irreconcilable.

Indeed, after the petition for a writ of certiorari was filed in this case, the Second Circuit decided a case presenting this same issue, *Raymond* v. *United States*, 355 F.3d 107 (2004). The Second Circuit held that principles of federal tax law require that the portion of a damages recovery paid to a Vermont attorney under a contingent fee agreement be included in the client's gross income. Discussing the taxpayer's contingent attorney's fees, the court of appeals stated that:

> Raymond "control[led] the source of the income [and] . . . divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants." [*Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940).] He diverted a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result "procurable only by the expenditure of money or money's worth." [*Id.* at 117]. Accordingly, the judgment flowing to Raymond is income to him, and the expense of producing that income—his attorney's fee—is a deductible expense. *See* [26 U.S.C.] § 212(1). That the Alternative Minimum Tax precludes Raymond from taking advantage of that deduction is unfortunate, * * * but it is not a reason to create an artificial contingent-fee exception to the rule that one is taxable on income from a source over which one retains control.

Id. at 115.

Thus, the Second Circuit has now joined the Fourth, Seventh, and Tenth Circuits in holding that federal tax law requires successful litigants to include in gross income the portion of a damages recovery paid to the litigant's attorney without regard to the rights of the attorney under state law to protect his claim for fees. As the Second Circuit's decision further demonstrates, the conflict over this issue is well developed and important. The Second Circuit itself noted that "[w]hether contingent fees are includable in the gross income of a client recovering on a judgment is the subject of much debate among the circuit courts," *Raymond*, 355 F.3d at 109, and it specifically referred to the Sixth Circuit's decision in this case as having widened the conflict by "diverging from [the Ninth Circuit's decision in] *Benci-Woodward* on *federal* grounds," *id.* at 110. This Court's review is necessary to resolve the conflict and to eliminate the disparity that now exists among similarly situated taxpayers.

2. Respondent's attempts (Br. in Opp. 6-8) to characterize the Sixth Circuit's decision in this case as consistent with established principles of tax law are unavailing. As explained in the petition (Pet. 8-11), it is a fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. A contractual arrangement mandating that income to be received in the future is to be paid directly to the taxpayer's assignee does not shift the incidence of the tax away from the party who assigned the right to receive the

income. See *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930); *Helvering* v. *Horst*, 311 U.S. 112, 114 (1940).

Contrary to respondent's assertions, the "anticipatory assignment" rule of *Lucas* and *Horst* applies with full force where the amount of the future income is not known at the time of the assignment and the assignee is obligated to provide services in exchange for the assignment. The contract at issue in *Lucas* involved an assignment of an uncertain amount of future income, see 281 U.S. at 113-114, and the fact that respondent's attorneys were obligated to perform services in exchange for the promised percentage of the litigation proceeds only demonstrates the error of respondent's argument (Br. in Opp. 7-8) that the portion of the settlement paid as attorney's fees was not income to him because he lacked control over it. Respondent exercised control over his right to the litigation proceeds when he promised a portion of those proceeds to his attorneys in exchange for legal services. As this Court explained in *Horst*, "where the enjoyment [of income] is consummated by some event other than the taxpayer's personal receipt of money or property," such as "when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth," the income is includible in the taxpayer's gross income. 311 U.S. at 116; see *id.* at 118.

3. Respondent argues that the question presented in the petition is of limited significance because legislation has been proposed in Congress that would amend the Internal Revenue Code to exclude from gross income "amounts received by a claimant (whether by suit or agreement and whether as lump sums or periodic payments) on account of unlawful discrimination." Br. in Opp. 8-10 (quoting proposed "Civil Rights Tax Relief

Act of 2003," H.R. 1155 and S. 557, 108th Cong., 1st Sess. (2003)). Such pending legislation, however, does not remove the need for this Court's review. First, the legislation has merely been proposed, and it is far from clear that it will ever be enacted into law, much less enacted soon enough to reduce the need for this Court's review. Both the Senate and the House bill were referred to committee on March 6, 2003, and it appears that no action has been taken on either bill since that time. See *Bill Summary & Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.01155:>; *Bill Summary & Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:s.00557:>.

Second, even if the proposed legislation were enacted, it would not eliminate the issue presented here. The proposed legislation would provide for the exclusion from gross income of amounts received on account of certain claims of unlawful discrimination. Recoveries for punitive damages, however, would still be included in gross income, as would recoveries for backpay and frontpay, subject to the benefits of income averaging.

The question presented in the petition potentially arises whenever litigants enter into contingent fee contracts, and such contracts are a routine feature of many types of litigation other than claims of unlawful discrimination. Accordingly, the issue will continue to arise, and will do so frequently, regardless of whether Congress enacts the proposed legislation identified by respondent. Indeed, in this case, respondent originally sued not only for alleged violations of federal anti-discrimination statutes, but also for state tort law claims for, *inter alia*, tortious interference with business relations. See Pet. App. 2a-3a. Although respondent

abandoned his state tort law claims prior to the settlement, *id.* at 3a, the court of appeals held that the settlement was attributable to his claim for backpay, rather than to any claim for personal injury. *Id.* at 15a-16a. Thus, it appears that the proposed legislation would not even obviate the need to resolve the question presented in this case, much less the myriad other cases in which the question arises.*

* * * * *

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

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* The proposed legislation, if enacted, would not apply to this case in any event, since by its terms it would only "apply to damages received in taxable years beginning after December 31, 2002." H.R. 1155 and S. 557, *supra*, § 140(c). This case involves respondent's 1990 tax year.